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¶1. This cable contains Post's Investment Climate Statement for 2010 and includes the following sections:

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INTRODUCTION

¶2. Azerbaijan's strategic development of its oil and gas resources continues to drive the country's economic growth, and keeps this country of barely nine million people at the forefront of world energy security discussions. Unfortunately corruption, lack of transparency, politically connected economic monopolies, and cronyism remain significant obstacles to economic progress, hindering both domestic as well as foreign investment. The nearly two decade-long, and as yet unresolved, conflict with Armenia, which left the country with over 700,000 refugees and internally displaced persons (IDPs) to care for, has also been a notable drain on public coffers.

¶3. 2009 once again confirmed the Azerbaijani economy's deep dependence on the global prices of oil, its main export commodity, and attendant market vagaries. The global economic crisis negatively affected both the opportunities and mood of emerging and established Azerbaijani businesses, though the country as a whole, with limited foreign debt and a general lack of integration with the global financial regime, largely escaped a serious impact. The financial and construction sectors suffered losses, but economic growth in real terms continued at a rather strong rate of over 9 percent. Fortunately, wide-scale anti-crisis measures and direct monetary injections by the Central Bank of Azerbaijan (CBA) helped to prevent a failure of the banking system; however, the insurance, securities and leasing markets were hit hard.

¶4. Sharp decreases in Azerbaijan's GDP growth rates, which reached 25-30 percent in recent years, were certainly noticed, but caused different responses from analysts and investors. Moody's Investor Service did not change Azerbaijan's ratings, but decreased the forecast on them from Positive to Stable. Fitch Ratings merely confirmed previous ratings, while Standard & Poor's changed its forecast from Stable to Positive. Foreign investments decreased significantly, mainly because of a slow period in new projects related to oil and gas. Due to increasing resource constraints, from decreases in both foreign investment and traditional budgetary inputs, Azerbaijan has begun to increase its foreign debt. This debt grew to 3.33 billion USD, an increase of eleven per cent in the first nine months of 2009. Foreign debt now comprises a relatively modest 8.7 per cent of Azerbaijan's Gross Domestic Product (GDP), and investment project credits made up 90 per cent of the external debt. These credits, also financed by the state budget, helped maintain a certain level of business activity in Azerbaijan's domestic economy.

¶5. Azerbaijan's revenues failed to meet state budget projections because profit tax incomes were down significantly for the first half of the year. The state budget is normally buttressed by direct allotments from the State Oil Fund, up to 50 per cent some years. However, receiving only one quarter of the forecast revenues from the country's largest sector, oil, which reportedly makes up nearly 65 per cent of the budget's income, had a strong negative effect. Budget incomes were 50 per cent less than projected for H1, 2009. The situation began to improve in H2, but experts surmise that full income and expenditure forecasts will not be reached. Also, in spite of the global financial crisis, Azerbaijan's strategic currency reserves, held by the State Oil Fund and the Central Bank, increased to 19.1 billion USD during the year, exceeding the January 1, 2009 projection of 18.55 billion USD.

¶6. Despite public presidential statements promising focused support for the agriculture, tourism and telecommunications sectors, Azerbaijan's dependence on the oil and gas sector increased. The sector's share in Azerbaijan's industrial production reached 75 per cent, an increase of greater than 11.1 per cent. Recently, the Azerbaijani President acknowledged that national economic development would depend on oil and gas and not on the non-oil sector for the next 10-20 years. Therefore, in order to decrease economic risk, the government of Azerbaijan (GOAJ) intends to manage hydrocarbon extraction uniformly until 2020. The non-oil sector strongly diminished, with a surplus of only 1.1 per cent in October against 13.9 per cent in February and March, when it seemed the non-oil sector might be able to rescue the entire economy.

¶7. For the first 11 months of 2009, 6.44 billion manat (AZN) was invested the Azerbaijan economy from all sources of financing. This was down 18.8 per cent against the same period in 2008. Local investments totaled 5.163 billion AZN or 80.1 per cent of all investments during this period, almost four times greater than the amount of foreign capital invested in the country's economy during those same 11 months. Local investments decreased by 16.5 per cent against the same period in 2008. Foreign investments reduced by 37.2 per cent and totaled 1.281 billion AZN. The majority of domestic investments, 69.3 per cent, fell to the state sector. The state budget for 2009 allocated 4.718 billion AZN for investment purposes, of which only 2.131 billion AZN was used during the first 11 months of the year.

¶8. So how does the GOAJ manage to continue to support a constantly "growing" economy? The answer lies in its reliance on enhancements from the State Oil Fund of Azerbaijan (SOFAZ), assets f which totaled 14.2 billion USD in reserves as f October 31, 2009. Annual transfers from SOFAZto the state budget are significant, but the GOAJ has stipulated that such transfers not exceed 50 per cent of SOFAZ's accumulated funds, while the rest be preserved as a social "safety net". The GOAJ is encouraged in its fiscal policies by the positive results of its efforts to protect the stability of the manat, the high level of foreign reserves, the relatively low level of foreign debt and increasing export-related incomes against the backdrop of recovering oil and gas prices.

¶9. The search for new exports Azerbaijan could offer to the world is still extremely passive. Sometimes this search for new exports is rather unclear or surprising, such as the production of pianos, badly assembled machines, or even the production of ostrich meat. Late in 2009, the GOAJ also stated its' intention to encourage industrial projects supporting the oil and gas sector. Related projects in the works include a methanol production plant and the construction of a shipyard in Baku. Both projects are primarily aimed at producing products for export. In the first, a private company will lead the project, estimated to cost over1.1 billion AZN. Construction on the factory began in 2007 and it is now 50 per cent complete. While the EBRD is stated to support this project, the first credit input of 120 million USD was received without a guarantee from EBRD. It is estimated that 30 million USD will be allotted to a quasi-joint-stock fund, where EBRD will most likely participate. Former UK Prime Minister Tony Blair, attended a signing ceremony for the enterprise in the fall of 2009. As for the shipyard, SOCAR has partnered with offshore and marine giant Keppel, which will have a 10 per cent stake in the venture.

¶10. Another hindrance to foreign direct investment is the difficulty of established Azeri businesses to adapt to standard investor-friendly practices, such as those associated with the concept of corporate governance. Because of their inability or unwillingness to comply with the attendant disclosure and financial transparency required for potential shareholders to confidently invest, many enterprises are unable to successfully market their companies on Azerbaijan's nascent stock market. There is a clear shortage of management expertise in the corporate sector.

¶11. Because of the volumes of money involved, the oil and gas sector is considered by many to be one of the greatest sources of corruption within the country, despite Azerbaijan being named the first participating country to be fully compliant with the Extractive Industries Transparency Initiative's (EITI) principles and criteria in 2009. However, corruption continues to plague Azerbaijan in every economic sector and is a serious impediment to the country's economic development. The Public Sector continues to be a common source of rent seeking, damaging both market reform potential and public moral. This leads to real amalgamation of political and economic authorities at even the most basic institutional levels. Under this system, neither commercial nor state powers can develop separately from each other. Thus, losing political power often means losing economic power, and vice versa, which leads to complete suppression of free economic competition and stagnation of true economic development. The struggle against corruption is extremely difficult under these conditions, and makes Azerbaijan's economic development even more problematic.

¶12. The official currency reserves of the Central Bank of Azerbaijan (CBA) - previously the National Bank of Azerbaijan - decreased from 10.8 billion USD to 5.09 billion in October. This decrease occurred after an increase of 6.6 per cent was observed in the previous three months. According to the CBA, its reserves have decreased 1.04 billion USD (17 per cent) since early 2009. CBA experts attribute this decrease to the dwindling of hard-currency reserves in Azerbaijan's commercial banks, the expenses of maintaining the manat's convertibility rate, and with the direct support of Azerbaijan's economy by the CBA that started in H2 of
¶2009.

¶13. According to the Heritage Foundation's 2010 Economic Freedom Index, Azerbaijan's economic freedom score is 58.8, making its economy the 96th freest of the 179 countries ranked. Its overall score is 0.8 points higher than last year, reflecting an improvement in investment freedom offset by modest declines in several other factors. Azerbaijan is ranked 16th out of 41 countries in the Asia-Pacific region, and its overall score is above the regional average but just below the world average.

A.1 Openness to Foreign Investment

¶14. The GOAJ officially welcomes foreign direct investment, realizing that it plays a vital role in development of the country's economy. Since 1994, Azerbaijan has attracted significant amounts of foreign investment to develop further its energy sector. However, government bureaucracy, weak legal institutions and predatory behavior by politically connected monopolistic interests continue to hinder investment outside of the energy sector. The application of the "single window" principle to Azerbaijan's Customs Service in January 2009 did not improve the country's rating in the World Bank's Doing Business Report for 2010. Azerbaijan even depreciated a step on the International Trade Management rating and became 177 of the 183 countries investigated.

¶15. The Law on Protection of Foreign Investments permits foreign direct investment (FDI) in any activity open to a national investor unless otherwise prohibited by law. Foreign investors can participate, according to the legislation, in privatization of state and municipal properties, as well as in properties with unfinished construction. In Azerbaijan, foreign investments have complete and unreserved legal protection granted by this law, other laws and international contracts. The Law on Protection of Foreign Investments permits foreign direct investment in most sectors. Prohibited areas include those relating to national security and defense, and the government carefully controls other key sectors, such as energy and communications. Non-transparent, arbitrary, and corrupt government bureaucracy; weak legal institutions; and predatory behavior by politically connected monopolistic interests have severely hindered investment outside of the energy sector. The law provides that Azerbaijan will treat foreign investors in a manner "not less favored" than the treatment accorded to local investors and allows repatriation of profits, revenues, and other investment-related funds as long as applicable taxes have been paid. Azerbaijan regulates most foreign exchange and capital transactions. Foreign citizens and enterprises may lease but may not own land. Expropriation may occur in the event of natural disaster, epidemic, or other extraordinary situation. Foreign investors are legally entitled to adequate compensation.

¶16. Azerbaijan is not yet a member of the World Trade Organization (WTO), but the GOAJ, with much international technical assistance, has been working to amend existing legislation in order to accede. The progress made in 2008 to achieve its rank as the World Bank's "Doing Business 2009" number one reformer ranking, and the adoption of many WTO-compliant legal reforms have been a visible result of the GOAJ's desire to accede to the WTO. The Ministry of Economic Development has been tasked to lead the WTO accession process, and Azerbaijan held two WTO Working Party Meetings in Geneva in 2008, in addition to bilateral discussions with USTR and the EU. Creating a stable and predictable business environment is especially crucial to attract investment to the non-energy sector. At present, however, efforts to improve the practical business environment are yet to be realized and Azerbaijan remains a challenging market in which to do business.

¶17. A "one-stop shop" system was applied at the State Migration Service beginning July 1, 2009. According to a Presidential Decree dated March 4, 2009, foreigners and people without citizenship arriving in Azerbaijan will be granted legal residence and work permits according to the single window principle within 7 days of application. The fee to acquire a one-year license for a migrant worker is equal to 1000 AZN (approximately 1250 USD).

¶18. Under Azerbaijani law, foreign investors may participate in the Azerbaijan market through joint ventures with local companies, or by establishing subsidiaries wholly owned by foreign investors, as well as through representative offices and branches of foreign legal entities. The Law on Protection of Foreign Investments provides that the Azerbaijani government will treat foreign investors in a manner "not less favored" than the treatment accorded to local investors. This law provides for repatriation of profits, revenues, and other investment-related funds so long as applicable Azerbaijani taxes have been paid. The law also provides a 10-year grandfather clause in the event new legislation less favorable to the foreign investor is adopted. However, this provision does not apply to changes in tax legislation.

¶19. While the GOAJ employs no formal screening mechanisms for general foreign investment, the process of registering an enterprise with the Ministry of Justice serves as a de facto screening process. Although by law this step is required only to determine that the documents of enterprises seeking registration are in order; the Ministry operates in a non-transparent and arbitrary manner. Credible reports indicate that ministry officials make extra-legal determinations of whether individual foreign investments are of an "appropriate" nature before making decisions about registration. Some investors have alleged that they have received demands for bribes or other illicit payments when attempting to register their enterprises.

A.2 Conversion and Transfer Policies

¶20. Azerbaijan has a liberal exchange system, and, in general, there are no restrictions on converting or transferring funds associated with an investment into freely usable currency and at a legal, market-clearing rate. Conversion is carried out through the Baku Interbank Currency Exchange Market and the Organized Interbank Currency Market. The Baku Electronic Currency Exchange System (BEST) was launched in July 2002. Cash exchange is carried out at numerous currency exchange points and no difficulties exist in obtaining foreign exchange.

¶21. Since 2001, the CBA has required that cash transactions be conducted in Azerbaijani manatsThe average delay for remitting investment returns is two to three business days. Additional requirements relating to the disclosure of the source of currency transfers have been imposed in an attempt to reduce illicit

transactions. Parliament amended legislation in 2007 to eliminate custom duties for cash currency exports, a move that is in-line with a WTO requirement and is believed to help ease inflationary pressures. The Tax Ministry has occasionally frozen bank accounts of companies that it believes have failed to meet their tax obligations.

¶22. A bill on non-bank lending agencies passed in Parliament on 25 December 2009, which will considerably improve the accessibility of financial services for the population and entrepreneurs. The State Committee for Securities continues to try to create a full-scale market of trading at the stock exchange. Approximately 20 companies that have applied for a listing on the Baku Stock Exchange (BSE) should appear in the stock market by the middle of 2010. The State Committee for Securities is also looking for new financial tools that could be introduced in the market, especially, debt conversion bonds. The value of deals with corporate bonds, state bonds and non-investment securities has increased this year. Mortgage bonds have also helped to invigorate the market. The bonds of 2009 have been floaed almost completely (44 million AZN of the 55 million AZN). The Azerbaijan Mortgage Fund can issue bonds totaling at least 100 million AZN.

A.3 Expropriation and Compensation

¶23. The Law on Protection of Foreign Investments protects foreign investors against nationalization and requisition except under certain specified circumstances. Nationalization of property to prevent harm to the population or damage to the state interests of Azerbaijan is possible by parliamentary resolution. Requisition by a decision of the Cabinet of Ministers is possible in the event of natural disaster, epidemic, or other extraordinary situation. In the event of nationalization or requisition, foreign investors are entitled by law to prompt, effective, and adequate compensation. There have been no cases of nationalization or requisition against foreign firms in Azerbaijan.

A.4 Dispute Settlement

¶24. Disputes or disagreements arising between foreign investors and enterprises with foreign investment; state bodies of the Azerbaijan Republic; or enterprises, public organizations and other legal entities of the Azerbaijan Republic are to be settled in Law Courts of the Azerbaijan Republic or, on agreement between the Parties, in a Court of Arbitration, including those abroad. Dispute settlement mechanisms exist in Azerbaijan, but effective means of protecting and enforcing property and contractual rights are by no means assured. While the Azerbaijani government does not officially interfere in the court system, in practice courts are weak; judges often inexperienced, easily intimidated or bought off; and progressive new tax and other economic legislation poorly understood. The Economic Court, which has jurisdiction over commercial disputes, is weak, widely regarded as corruptible, and its decisions are often inconsistent. The Civil Procedure Code of September 2000 sets forth basic civil legislation.

¶25. Since 2000, the Law on International Arbitration provides for the possibility of local arbitration in international commercial matters. However, in practice arbitration is seldom used to resolve disputes. A Bilateral Investment Treaty between the U.S. and Azerbaijan, which came into effect in 2001, provides U.S. investors with recourse to the International Center for the Settlement of Investment Disputes. Azerbaijan is a party to the World Bank Convention on the Settlement of Investment Disputes between States and Nationals of Other States and is also a member of the Multilateral Investment Guarantee Agency (MIGA). Azerbaijan is also a party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which provides for binding international arbitration of investment disputes between foreign investors and the state. The Civil Procedure Code provides that foreign arbitral awards may be enforced in Azerbaijan so long as they do not contravene local legislation or public policy, and if reciprocity exists.

¶26. Investment disputes have arisen in Azerbaijan when a foreign investor's success threatened well connected or favored local interests. Reportedly, resolution of such disputes has occasionally involved the foreign investor acquiring a local partner with strong ties to influential persons. Azerbaijan's bankruptcy law does not function effectively and is rarely used. However, USAID continues to work directly with the Ministries of Economic Development and Justice to promote a legal/regulatory reform of the bankruptcy/business closure system.

A.5 Performance Requirements and Incentives

¶27. Azerbaijan has not yet developed effective incentives to attract foreign investment, other than the incentives provided by Production Sharing Agreements in the oil and gas sector; however a special economic zone law was created and passed by Parliament on 25 December 2009. Performance requirements are not imposed on new investment, but investors who participate in the privatization process of enterprises often assume specific obligations regarding future investment and employment. Foreign investors are not required to purchase from local sources or export a certain percentage of output. Except for certain state monopolies, there is no requirement that nationals own shares in enterprises. Investors in PSAs assume obligations and requirements as provided within the PSA.

¶28. There are currently no legal requirements for employment of host country nationals, though this policy may be under review by parliament. Employers wishing to hire foreign workers in Azerbaijan must obtain a license from the Ministry of Labor. Foreigners who wish to work in Azerbaijan must register with local authorities at their place of residence and obtain work permits from the Ministry of Labor. Heads of representative offices and branches of foreign

legal entities and their deputies do not require work permits, because they are not considered migrant laborers. In 2008, the Government introduced a work permit regime for all immigrant employees. Unfortunately, due to a lack of transparency and printed fee schedule, there exist opportunities for confusion and corruption.

¶29. As of July 1, 2009 Azerbaijan began applying "one window" principle to the State Migration Service; however, reports of the efficacy of the new system are varied.

A.6 Right to Private Ownership and Establishment

¶30. Under Azerbaijani law, foreign investors may engage in investment activities not prohibited by law. Private entities may freely establish, acquire, and dispose of interests in business enterprises. In practice, access to markets, credit and other business operations is often impeded by licensing and other regulatory requirements and by politically connected business interests that can mobilize the powers of the state to their advantage. In sectors of interest to certain senior government and political figures, competition is actively impeded through administrative barriers.

¶31. Legislation regulating real property rights include the Law on Mortgage (2005), Land Code of the Republic of Azerbaijan (1999), the Law on Land Reform (1996), the Law on Land Leasing (1999), and the Law on Land Market (1999). New laws on collateral and cadastral law have been drafted which could significantly strengthen creditor rights, and improve the transparency and fluidity with which markets for real and moveable property function. Azerbaijani citizens and legal entities, including enterprises with foreign investment, can legally own, buy, sell, and trade property. Foreign citizens and enterprises may lease, but cannot own, land.

A.7 Protection of Property Rights

¶32. Azerbaijan's judiciary is corrupt and inefficient and does not function independently of the executive. The poor quality, reliability, and transparency of governance, as well as regulatory abuse and poor contract enforcement, significantly impede the ability of many companies to do business. Politically connected business interests benefit from their control of lucrative sectors. Amendments to the Civil Code adopted in 2007 that permit the authorities to forcibly purchase property are likely to create additional opportunities for the abuse of property rights.
¶33. Secured interests in property, both movable and real, are technically recognized. While the Government, together with World Bank, has been working to improve the property registration system, the system is filled with bureaucratic requirements and is generally seen as corrupt and inefficient. In 2006, the Government centralized the processing of residential real estate transactions through a network of notary offices under the Ministry of Justice.

¶34. In the mid-1990s, Azerbaijan began implementing a national system for registering and protecting intellectual property rights with the assistance of the World Intellectual Property Organization (WIPO), of which it is a member. Azerbaijan enacted improved copyright legislation (Law on Copyright and Related Rights) in 1996, patent legislation (Law on Patents) in 1997, and trademark protection legislation (Law on Trademarks and Geographic Names) in ¶1998. Azerbaijan is also a party to the Convention Establishing the World Intellectual Property Organization, the Paris Convention for Protection of Industrial Property, and the Berne Convention for the Protection of Literary and Artistic Works. Azerbaijan is also a party to the Geneva Phonograms Convention, and acceded to the two WIPO Internet treaties in 2005.

¶35. The State Copyright Agency has formed an anti-piracy commission, with representatives from various ministries. While the Agency has made some progress by conducting raids and initiating civil court proceedings for violation of copyrights, in practice, there is extremely limited enforcement of intellectual property rights. Pirated software and movies, as well as knock-off clothing and luxury items, are widely available in Azerbaijan; whereas, in contrast, legitimate movies are not. Shortcomings in its intellectual property rights laws and enforcement thereof resulted in Azerbaijan remaining on the U.S. Special 301 Watch List from 2000 to 2005. Improvements in IPR enforcement allowed Azerbaijan's removal from the list in 2006. As part of its WTO accession program, Azerbaijan has recently developed a range of WTO-consistent IPR legal and regulatory reforms, which could significantly strengthen IPR rights and enforcement protections, particularly if enforced.

A.8 Transparency of the Regulatory System

¶36. Although the Azerbaijani government has improved its regulatory system in the past several years, lack of transparency and allegations of corruption remain key problems in this area. The lack of transparent policies and effective laws to establish clear rules and foster competition are particularly serious impediments to investment. Informal bureaucratic control mechanisms often impede with application of laws and regulations and hinder competition.

¶37. While laws and decrees are usually published in one of the country's official newspapers, implementation is often delayed while regulations are developed. Those regulations in many cases are not published or distributed. In 2008, the government began a concerted effort to improve the transparency and predictability of the business regulatory environment with the assistance of USAID, the World Bank (WB) and the International Finance Corporation (IFC). This is reflected in the well published progress made in the World Bank's 2009 "Doing Business" rankings. The major areas of improvement included establishing a one-stop shop for business registration, streamlining property registration and transfer procedures, automation of key tax administration processes,

broadened coverage of the credit registry system, and improved corporate governance guidelines. The improvements made generally benefit local small businesses more than they benefit large foreign investors. Significant areas for improvement remain, including customs operations, business closure, and business permitting systems. And while Azerbaijan maintained its ranking, it did not improve significantly from the 2009 to the 2010 report.

¶38. Previously, Azerbaijan announced plans to adopt 29 national accounting standards to be in-line with International Financial Reporting Standards (IFRS) by 2009. Audited financial statements have only been adopted in banking and finance, where foreign ownership is most advanced.

¶39. Moore Stephens published a new report covering the Extractive Industry Transparency Initiative (EITI) in Azerbaijan in December,
¶2009. According to the report, non-resident companies operating in Azerbaijan extracted 92.8 million barrels of oil and 2,086 million cubic meters of natural gas in H1 of 2009. Those foreign companies paid a total enterprise profit tax of 133.061 million AZN and transit fees of 6.2 million AZN. The Local companies paid royalties of 40.6 million AZN, a total enterprise profit tax of 136.1 million AZN and other taxes of 46.3 million AZN. The foreign companies contributed 62 million USD and 356 million AZN to Azerbaijan's government in the period reported. In Transparency International's annual report on corruption perception in the world, Azerbaijan ranked 143rd on the list, while neighboring Armenia and Georgia ranked 120th and 66th, respectively. In 2008 Azerbaijan ranked 158th. The most corrupt spheres in Azerbaijan are considered to be law enforcement agencies, organs of executive power, medicine, and education.

A.9 Efficient Capital Markets and Portfolio Investment

¶40. As of December 2009, there were 46 banks in Azerbaijan. The banking sector is dominated by the International Bank of Azerbaijan (IBA), which controls more than 50 per cent of the banking sector. Foreign ownership in the banking sector is limited to 50 per cent on an aggregate basis. There are 23 banks with foreign capital. According to the CBA, as of December 2009, total assets of the Azerbaijan banking system were 13.9 billion USD. Banks' assets rose by 12.7 per cent year-on-year. As of December 1, 2009 the volume of individual deposits in the Azerbaijani banks equaled 2,251,700,000 AZN. In 2007 Azerbaijan established the National Depository Insurance Fund, which, as of December 2000, had 42 banking members. The average cost of credit ranges from 20 to 24 per cent, and the maximum interest rate on protected deposits is also quite high (15 per cent). The amount of guaranteed secure deposits has also increased to 30,000 AZN.

¶41. In early 2009 the Central Bank of Azerbaijan's (CBA) took unprecedented measures (as did many other countries) to support the banking system, which began to recover in April. A variety of methods were used, including decreasing the refinancing rate for a short time to 2 per cent, decreasing the mandatory reserve rates and providing direct credit support for several banks, including two larger banks. After stabilizing the bank system, the CBA began to directly financing the real economic sector under state guarantees at the GOAJ's request. For the first time the CBA had the right to provide long-term credits in AZN and hard currency. The measures taken to maintain the economy and banks' liquidity (CBA provided them with over 1.8 billion AZN) helped to sustain economic growth in Azerbaijan. After brief reduction in January 2009, the CBA's official currency reserves grew by 88.2 million USD (1.7 per cent) in November, totally 5.18 billion USD. Nevertheless this was 955.9 million USD (15.6 per cent) less than in early 2009. About one-third of these funds were spent on currency interventions. The rest of the losses resulted from a decrease in the commercial banks' currency reserves created on external liabilities and kept in the CBA. The average annual inflation for the first 11 months of 2009 against the same period of 2008 was 1.5 per cent.

¶42. Previously, a presidential decree required installation of point of sale (POS) terminals in all shops within two years beginning in January 2006. Despite some progress in installation of POS terminals, the vast majority of stores and restaurants still do not carry POS terminals or, if they do, avoid running card transactions to minimize taxation. The Baku Interbank Currency Exchange (BICEX) carries out inter-bank auctions of foreign exchange and Treasury bill auctions are conducted by the Baku Stock Exchange, established in 2000. Overall the securities market remains at a very nascent stage of development. In June 2009, Fitch Ratings affirmed Azerbaijan's long-term issuer default ratings as BB+ with a stable outlook. In December, Standard and Poor's announced an upgrade to its outlook on Azerbaijan from stable to positive, while maintaining its long- and short-term sovereign credit ratings at BB and B, respectively. In June 2009 Moody's Investor Service lowered its outlook on Azerbaijan's Ba1 issuer rating from positive to stable. Moody's Weighted Average Bank Financial Strength Rating for Azerbaijan remained "E+".

A.10 Competition from State Owned Enterprises (SOEs)

¶43. Private enterprises are not generally allowed to compete with public enterprises in strategically important fields, such as oil and gas production/export, although there are some small private companies operating in this sector. Other non-competitive fields include electricity generation (Azerenerji) and water supply (Azersu).

¶44. There is no corporate governance structure in any State owned enterprises, with the exception of the State Oil Fund of Azerbaijan (SOFAZ). SOFAZ operates as a sovereign wealth fund and Members of the Supervisory Board are appointed by the President of Azerbaijan. Board members are representatives of state bodies and civil society. There are seven members on the supervisory board, including two members of the Milli Majilis (parliament), who are nominated by the Speaker of Parliament. The Executive Director, Shahmar Movsumov, was appointed by the President on May 15, 2006. He is the legal

representative of the Fund, and is responsible for appointing employees, managing the Fund's assets, and preparing the Fund's annual budget. In 2010 SOFAZ will transfer roughly 4.91 billion manat to the budget. It is also charged with funding several social welfare projects including construction of the Oguz-Gabala Water Supply System (200 million AZN), reconstruction of the Samur-Absheron Irrigation System (110 million AZN), improving the lives of refugees and IDPs(80 million AZN), construction of the Baku-Tbilisi-Kars Railway (80 million AZN) and a youth education program which subsidizes study abroad (10 million AZN).

¶45. SOFAZ, as a member of the Extractive Industries Transparency Initiative (EITI), is required to publish an annual report and submit its books for independent audit. Other SOEs are also required to fulfill these obligations, but only a very few are made available to the public.

A.11 Corporate Social Responsibility

¶46. The notion of Corporate Social Responsibility is a relatively new concept for Azerbaijani companies. While some major holdings companies publish a CSR section on their websites, these sections are by and large empty. Local companies are still learning about CSR and what it means for them; many do not yet differentiate CSR from charitable donations. Major local and international energy and telecom companies (BP, Azercell, Azerfon etc.) have a better grasp of CSR and are generally regarded quite well.

A.12 Political Violence

¶47. There have been no acts of political violence against U.S. businesses or assets, nor against any foreign-owned entity. The risk of political violence affecting foreign investors remains minimal. In 2006 and 2007, the Azerbaijani authorities arrested two separate groups that were accused of plotting terrorist acts against Western interests. Police periodically use force to disperse unauthorized demonstrations or spontaneous acts of public discontent; police also used force to break up a peaceful protest of conflict in Gaza in January 2009.

A.13 Corruption

¶48. Corruption is a significant deterrent to investment in Azerbaijan, especially in the non-energy sector. Laws and regulations that exist to combat corruption have not been effectively enforced. A new anti-corruption law came into force in January 2005. Under the terms of the law, a new commission has the authority to require full financial disclosure from government officials. However, Azerbaijan made little progress in implementing this law. The Azerbaijani government recognizes that corruption is a problem, although it frequently disagrees with the results of international rankings produced by groups such as Transparency International. Popular opinions identify the State Customs Committee as the institution of greatest concern to businesses in Azerbaijan, followed by the Ministry of Taxation. Corruption appears most pervasive in the regulatory, tax and dispute settlement systems. Throughout the country, problems in the quality, reliability and transparency of governance, as well as abuse of the regulatory system and poor contract enforcement, significantly impede the ability of many companies to do business in Azerbaijan and have driven many companies, including some major Western firms, from the market.

¶49. In the past several years, politically connected businesses

appear to have benefited from government regulatory and other decisions to achieve effective control over several lucrative sectors of the economy, and U.S. investors have been among those victimized. Currently, powerful state-owned enterprises, such as the Azerbaijan State Caspian Shipping Company (CASPAR) and Azerbaijan Airlines (AZAL), have protected their commercial interests by blocking new entrants into the market through the exercise of their regulatory authority -- a clear conflict of interest. A focus of current international community work in Azerbaijan is combating corruption and improving governance. In 2004, Azerbaijan joined the Council of Europe's Group of States against Corruption (GRECO), but Azerbaijan is not a signatory to the OECD Convention on Combating Bribery.

¶50. In 2009 Azerbaijan became the first participating country to achieve "fully compliant" status in Extractive Industries Transparency Initative (EITI), which it joined in 2004 to promotemore transparent management of oil revenues. As prt of its obligation under this program, Azerbaijan issues annual and semi-annual reports and released its 11th EITI report on 14 December 2009 covering the period Jan-Jun 2009.

¶51. Over the past few years the GOAJ has spent large amounts on developing Azerbaijan's road-transport system; however the absence of proper financial controls opens broad opportunities for corruption in implementing these projects. This was the core opinion expressed by the EITI Public Unions Coalition, a union of social watchdog NGO's, at their December 2009 conference entitled: "Prospering Baku: how much does it cost us?" Local economics expert, Gubad Ibadoglu stated in his report that the financing of major projects from the state budget do not follow standard best practices for cost benefit analyses. He pointed out that contractors for these lucrative projects are not selected through tenders; they are appointed. He also noted that these large social investment projects are not even monitored by the state Accounting services. Such projects include: the reconstruction and expansion of Heydar Aliyev avenue (estimated to value over 40,691,000 AZN), a new road from Azizbekov metro station to the international airport (298,492 AZN), the construction of an intersection near the Excelsior Hotel (95,590,100 AZN) , and the construction of an intersection near Azizbekov metro (128,896,400 AZN). Al Jazeera broadcast an intriguing report in 2009, claiming that a

government-funded road from Baku to the airport was built at a cost of 23 million USD per kilometer, while a World Bank-funded road south of the capital was built at a cost of 1.5 USD million per kilometer

A.14 Bilateral Investment Agreements

¶52. Azerbaijan has signed agreements on mutual protection of investments with 39 countries and on the avoidance of double taxation with 38 countries. On October 18, 2000, the U.S. Senate ratified the Treaty between the Government of the United States of America and the Government of the Republic of Azerbaijan Concerning the Encouragement and Reciprocal Protection of Investment (commonly known as a "Bilateral Investment Treaty" (BIT). Azerbaijan and the U.S. exchanged instruments of ratification on July 3, 2001, and the treaty entered into force on August 2, 2001.

¶53. In addition to the above agreements, Azerbaijan has bilateral investment protection agreements with the following countries: Austria, Belgium, Bulgaria, China, Egypt, Finland, France, Georgia, Germany, Greece, Iran, Italy, Kazakhstan, Kyrgyzstan, Latvia, Libya, Moldova, Pakistan, Poland, Saudi Arabia, Switzerland, Turkey, UAE, Ukraine, and the United Kingdom.

A.15 OPIC and Other Investment Insurance Programs

¶54. OPIC provided 100 million USD in political risk insurance to U.S.-based financial institutions and U.S. equity partners in the Baku-Tbilisi-Ceyhan oil pipeline. In 2002, OPIC invested 50 million USD in Soros Investment Capital for projects targeted to all three Caucasus countries. OPIC also disbursed a 4.6 million USD loan to Caucasus Airlines, a regional air carrier based in Tbilisi. Caucasus Airlines ceased operations in late 2004 after a dispute arose with Azerbaijan's state air carrier AZAL over terms on the Baku-Tbilisi route. In 2005, OPIC provided financing to Baker Oil Tools for a joint venture with the State Oil Company of the Azerbaijan Republic (SOCAR). In 2006, OPIC provided USD 7.5 million to ShoreBank International Ltd for SME and mortgage loan portfolio expansion in Azerbaijan.

¶55. In March 2004, the Export-Import Bank of the United States (Ex-Im Bank) provided a 19.3 million USD loan guarantee to Saba, Inc., a mid-sized U.S. company, for engineering, design, and construction services to build a business and residential center in Baku.

¶56. In December 2009, the Israel Export Insurance Corp. Ltd. (ASHRA) provided a project loan guarantee to Azerbaijan for the first time. The Ministry of Transport of Azerbaijan announced that country's finance and transport ministers signed a loan agreement with France's BNP Paribas to reconstruct several highways in Azerbaijan. The 270 million USD loan was designed to reconstruct a 156 km section of the Baku-Shemakha-Yevlakh (M4) highway, total length 280 km, from Muganli-Yevlakh. The loan was granted for 14 years with a 4-year grace period, and will be repaid in six-month tranches - on 15 June and 15 December every year. Loan rate is rate of 6-month LIBOR in US dollars plus a margin of 3.5 per cent per annum. 70 per cent of the loan will be provided by BNP Paribas (189 million USD) and 15 per cent by Israel's BANK LEUMI LE ISRAEL B.M. and BANK HAPOALIM B.M (40.5 million USD).

A.16 Labor

¶57. Azerbaijan has an abundant supply of qualified, trained technicians and skilled and unskilled laborers at attractive rates to employers. At the same time, companies cite increasing problems with hiring skilled professional staff, which could be result of a decline in quality education and labor emigration. The collapse of the old Soviet industrial sector in this country during the 1990s resulted in large numbers of Azerbaijanis becoming unemployed or underemployed. Government sources estimate the rate of unemployment at six-seven per cent, but other sources quote up to twenty per cent or more, with underemployment much higher. As of September 2008, the minimum monthly wage was 75 AZN (a 25 per cent increase). President Aliyev ratified a law on December 22, declaring the living-wage for 2010 to be 87 AZN. This means there are many workers, including government employees whose official salaries put them below the poverty line. A Labor Code that took effect in 1999 regulates labor relations. The workweek is generally forty hours, the right to strike exists, but industrial strikes are rare. Azerbaijan is a member of the International Labor Organization (ILO) and has ratified more than 50 ILO Conventions. Azerbaijan is currently working with the World Bank on a program to reform the state pension system. In the first 11 months of 2009, the State Migration Service received over 40,000 registration appeals. About 2,000 migrant workers were registered in Azerbaijan three years ago during the same period. Most are from CIS countries such as Georgia and Russia, but also Turkey, Iran, the U.S., and UK. The State Migration Service also receives frequent appeals from foreigners seeking refugee status in Azerbaijan. Most are from Pakistan and Afghanistan and some are from Iran.

A.17 Foreign Trade Zones/Free Ports

¶58. Although the government announced in 2003 its intention to create special economic zones, there are currently no foreign trade zones or free ports operating in the country. The Ministry of Economic Development has announced plans to create a special economic zone near a new Caspian port to be completed in 2012. The Ministry of Communication and Information Technologies has conducted a feasibility study to create Regional Innovation Zones with an aim to boost development of the telecommunications sector and to turn Azerbaijan into a regional information and communication technology hub.

¶59. Azerbaijan's Cabinet of Ministers has approved simplified rules

for customs controls, customs checkpoints, customs clearance of goods, and the crossing of vehicles and individuals at the boundaries of special economic zones (SEZ). According to these rules, customs checkpoints may be established in the SEZ by the State Customs Committee unless otherwise provided for customs registration by the law. For these purposes, electronic control and declarations may be used. Under the new rules, goods imported into and exported from the SEZ are not subject to import duties and VAT, or customs duties and taxes (excluding excise duty).

A.18 Foreign Direct Investment Statistics

¶60. Below numbers are the latest available from the State Statistical Committee of Azerbaijan:
Investments (million USD)2004200520062007   2008TOTAL
INVESTMENTS5922.77118.58300.412066.1 15192.1Foreign
Investment4575.54893.25052.86674.3   6847.4Domestic
847.4
Domestic
Investments1347.22225.33247.65391.8   8344.7

Foreign Investments (mln. US dollars)

	2000	2003	2004	2005	2006	2007	2008
Total For. Inv.	927.0	3371.0	4575.5	4893.2	5052.8	6674.3	6847.4
of which:							
Financial Credits	262.9	238.3	293.0	698.4	983.5	1576.6	2357.9
In Oil Industry	546.1	2972.4	4088.1	3799.9	3422.3	4003.3	3350.7
Bonus of Oil	-	58.6	21.6	1.0	17.0	68.2	3.5
Foreign Co.s and JVs	118	45.4	104.2	230.5	368.4	439.1	494.1
of which:							
Turkey	31.6	17.1	80.1	96.2	136.6	109.2	145.2
USA	11.2	4.9	8.4	24.8	70.0	78.0	87.9
Iran	2.9	-	-	1.2	17.5	4.6	-
Germany	1.7	-	2.1	21.5	17.4	22.9	48.2
Russia	-	1.2	1.8	5.1	4.6	10.7	5.8
U.K.	6.8	9.0	4.2	39.5	39.1	80.0	89.9
UAE	2.8	4.4	4.4	5.7	18.3	12.3	38.5
Switzerland	-	-	-	0.5	2.7	3.5	3.7
3.7							
France	39.3	2.2	2.2	2.6	11.1	4.4	-
Cyprus	-	-	-	0.2	5.4	13.2	2.2
China	-	-	-	0.2	1.3	1.2	8.1
Italy	-	-	-	4.6	2.8	14.0	2.0
Pakistan	-	-	-	-	3.1	-	-
Japan	16.4	-	-	-	-	-	0.4
Other Countries	5.3	6.6	1.0	28.4	38.5	85.1	62.2
Other Investments	-	56.3	68.6	163.4	261.6	587.1	641.2

Major Foreign Investors:

Significant foreign investors in the energy sector include BP, Unocal, ExxonMobil, Devon Energy (Pennzoil), TPAO, Statoil, Lukoil, Itochu, Agip, ChevronTexaco, ENI, Halliburton, Schlumberger, Kvaerner, and Aker Maritime (Technip-Coflexip). Significant non-energy investments include Garadagh Cement, Castel (brewery), Coca Cola, Pepsi Cola, Azercell (mobile telephony), Bakcell (mobile telephony), Azerfon (mobile telephony), and Hyatt Hotels Baku.